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DEFINING "TRADE OR BUSINESS" UNDER THE INTERNAL REVENUE CODE: A SURVEY OF RELEVANT CASES

E. JOHN LOPEZ

I. INTRODUCTION

The phrase "trade or business" is used repeatedly throughout the Internal Revenue Code.¹ Despite its widespread use, the phrase is not defined either in the Code² or in the Treasury Regulations.³ However, the phrase has been developed and refined over the years through judicial interpretation.⁴ One court has stated that the question of whether a particular set of facts comes within the realm of trade or business appears to be, like many other legal points, one which is being marked out by the judicial process of inclusion and exclusion most commonly associated with distinctions of degree rather than kind.⁵ Unfortunately, courts have chosen different paths in their search for a definition. One is left with much uncertainty as to whether any particular set of facts constitutes a trade or business.

The question of whether an income-producing activity constitutes a trade or business is important in determining which, and to what extent, expenses attributable to that activity can be deducted. Although the Code and the Regulations do not provide a definition, the Internal Revenue Service has defined "trade or business" as

an activity carried on for livelihood or for profit. For an activity to be considered a business, a profit motive must be present and some type of economic activity must be involved. It is distinguished from an activity engaged in purely for personal satisfaction.

A business usually has regular transactions that produce income. To carry out these transactions, it has to incur a number of expenses. . . . The difference between the amount of money it takes in . . . and the amount it pays out is its profit or loss. If in

1. According to one commentator, the Code of the late 1950's contained more than 170 references to "trade or business." See Saunders, *"Trade or Business," Its Meaning Under the Internal Revenue Code*, 1960 MAJOR TAX PLAN. 693, 693.

2. There are a few definitions limited to special situations, such as I.R.C. §§ 355(b), 502(b) & 7701(a)(26) (CCH 1983).

3. Roth, *Trade or Business Requirement of Sec. 162 and the Deductibility of Preoccupancy Expenses Incurred in Rental Real Estate Projects*, 57 TAXES 33, 39 (1979).

4. See *Green v. Comm'r*, 74 T.C. 1229, 1234 (1980).

5. *White's Will v. Comm'r*, 119 F.2d 619, 621 (3d Cir. 1940).

one year your business has a loss because you have little or no income to offset your expenses, there may be a question as to whether a business was carried on in that year.

You should be able to show annually by *facts and circumstances* that you were in business during that year.⁶

As to what actually constitutes a trade or business, one must consult the relevant case law construing the phrase. This comment will present a brief summary of relevant cases tracing the evolution of the phrase and then follow with a discussion of its use in two areas which often give rise to litigation: (1) the investor who expends time and money in the management of his personal securities portfolio, and (2) the person who promotes, develops, and finances various business enterprises, especially those corporations which are closely or solely-held.

While this survey explores the outer bounds of what constitutes a trade or business, the reader will come away with only the broadest generalizations. Examining the case law will provide the best direction available, but unfortunately will also leave many questions unanswered.

II. EVOLUTION OF THE TERM "TRADE OR BUSINESS"

The first significant judicial effort to define "trade or business" came in *Flint v. Stone Tracy Co.*⁷ In that case, the Supreme Court stated:

"Business" is a very comprehensive term and embraces everything about which a person can be employed. . . . "[It is] that which occupies the time, attention and labor of men for the purpose of a livelihood or profit. . . ."

We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings, making investments of profits, or leasing ore lands and collecting royalties, managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute, and in the capacity necessary to make such organizations subject to the law.⁸

In 1940, the Supreme Court refined its definition in *Deputy v.*

6. IRS PUB. NO. 334, TAX GUIDE FOR SMALL BUSINESS 2 (1981) (emphasis added).

7. 220 U.S. 107 (1911).

8. *Id.* at 171 (citations omitted).

du Pont.⁹ In a concurring opinion, Mr. Justice Frankfurter stated that "‘carrying on any trade or business,’ within the contemplation of section 23(a), involves holding one’s self out to others as engaged in the selling of goods or services.”¹⁰ Moreover, Justice Frankfurter noted that “[e]xpenses for transactions not connected with trade or business, such as an expense for handling personal investments, are not deductible.”¹¹

The next stage in the evolution of the phrase occurred one year later in the case of *Higgins v. Commissioner*.¹² In *Higgins*, the taxpayer devoted considerable time to the management of his extensive holdings in real estate, stocks and bonds. He hired a staff to assist him and rented office space in New York and Paris. The offices kept records, made deposits, received securities, interest and dividend checks, forwarded weekly and annual reports, and generally undertook the care of Higgins’ investments.¹³ Higgins claimed the expenses associated with the management of his portfolio as business expenses deductible in the computation of his adjusted gross income.¹⁴ The Commissioner disallowed the deduction.¹⁵

On appeal to the United States Supreme Court, Higgins urged that the continuity, constant repetition, regularity, and magnitude of his activities elevated him from the class of small investors and therefore qualified him as being in the trade or business of investing. The Supreme Court, in deciding whether this activity constituted a trade or business, formulated a test which has since received widespread use. The Court stated that a determination of whether a taxpayer’s activities rise to the level of trade or business requires an examination of the facts in each case.¹⁶ Although the Court was less than precise in formulating the appropriate analytical framework for *Higgins*-type cases, it was clear on one point. In regards to whether personal investment activity could ever rise to the level of a trade or business, the Court said that “no matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision” that such activities do not con-

9. 308 U.S. 488 (1940).

10. *Id.* at 499 (Frankfurter, J., concurring). Section 23(a) referred to in the quote is now found at I.R.C. § 162(a) (CCH 1983).

11. *du Pont*, 308 U.S. at 499.

12. 312 U.S. 212 (1941).

13. *Id.* at 213-14.

14. *Id.*

15. *Id.*

16. *Id.* at 217.

stitute carrying on a business.¹⁷

The next important step in the evolution of the term "trade or business" occurred in *Gentile v. Commissioner*.¹⁸ The petitioner in *Gentile* was a full-time gambler. In addition to betting on the horses, he also derived income from his other gambling activities, including private wagers on televised sports events, and card and dice games. Although Gentile had a criminal record of arrests and convictions for gambling-related offenses, during the year in issue he did not operate a gambling establishment, place wagers for other persons, maintain an office, or give gambling advice for which he was compensated. "His activity was confined to putting his own money 'on the table.'"¹⁹

After Gentile filed his tax return, the Service assessed a deficiency claiming Gentile was engaged in a trade or business.²⁰ Gentile, while readily admitting the regularity of his gambling activities, maintained that he was not in a trade or business because he neither provided nor held himself out as a provider of any goods or services to any other person. The Service, instead of limiting a trade or business to the offering of goods or services to others, argued that it is the individual's everyday efforts to earn a living, characterized by continuity, regularity, and a profit motive that constitute business activity.²¹

The Tax Court heard the case and held that while these three elements may be necessary to establish that Gentile was engaged

17. *Id.* After the *Higgins* decision Congress enacted I.R.C. § 212 to make available to investors the section 162 deductions. Section 212 now makes deductible all the ordinary and necessary business expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. It does not extend the concept of trade or business to personal investment. According to a discussion in the Congressional Record regarding the proposed § 212:

Trade or business has received such a narrow interpretation that many meritorious deductions are denied. The Supreme Court, in the case of *Higgins v. Comm'r*, held that expenses in connection with a taxpayer's investments in income-producing properties were not deductible, on the ground that making casual investments was not a trade or business. Since the income from such investments is clearly taxable it is inequitable to deny the deduction of expenses attributable to such investments.

To cure this inequity, the bill contains a provision which will allow taxpayers to deduct expenses incurred for the production or collection of income whether or not such expenses are connected with the taxpayer's trade or business.

88 CONG. REC. 6376 (1942) (citations omitted).

18. 65 T.C. 1 (1975).

19. *Id.* at 2-3.

20. The Service took this position in order to subject Gentile to the self-employment tax imposed by I.R.C. § 1401.

21. *Id.* at 3.

in a trade or business, something more than the production of income for federal income tax purposes is required. The court, relying on the test formulated by Justice Frankfurter in *du Pont*, reiterated that "trade or business" contemplates "holding one's self out to others." Thus, the court reasoned, since Gentile was not "holding himself out to others" as a businessman when he placed his bets, he was not in the trade or business of gambling and therefore was not subject to the self-employment tax of section 1401. The court said this activity was similar to the study of market reports for the management of one's investment portfolio—an activity "clearly not within the bounds of a trade or business."²²

Finally, one of the most recent stops in the journey to define trade or business, and one which signaled the abandonment of the "holding one's self out" test, is the case of *Ditunno v. Commissioner*.²³ In *Ditunno* the sole issue, like that in *Gentile*, was whether a full-time gambler's losses are deductible as a trade or business expense.

Anthony J. Ditunno was a full-time gambler, having no other profession or employment. During the years 1977 to 1979,²⁴ Ditunno gambled on the horse races six days a week, year round. He did not bet on every race, but instead studied racing forms and bet mainly on the "doubles" and "trifecta" races. Ditunno never placed bets on behalf of other persons, nor did he sell tips to other gamblers. He never received commissions and was not a bookmaker. The Service rejected Ditunno's attempt to claim trade or business deductions and determined deficiencies in his income tax. Ditunno refused to accept the Service's position and chose instead to take his case to the Tax Court.²⁵

Arguing his case pro se, Ditunno claimed his gambling losses as deductions from gross income. Specifically, he claimed his gambling losses were trade or business deductions, qualifying under section 62(1).²⁶ The Service maintained that Ditunno *was not* in

22. *Id.* at 6. The court cited *Higgins* as support for this proposition.

23. [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2857 (Feb. 7, 1983).

24. The Service determined deficiencies in Ditunno's federal income taxes for these three years. The amount of each deficiency was \$1,992 for 1977, \$2,364 for 1978, and \$787 for 1979. [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2858.

25. *Id.*

26. *Id.* I.R.C. § 62(1) (CCH 1979) states that "the term 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions: TRADE AND BUSINESS DEDUCTIONS — The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer."

the trade or business of gambling.²⁷ Therefore, the gambling loss deductions would not qualify under section 62 as deductions allowable in computing adjusted gross income.²⁸ The Service, reversing the position it had taken in past cases, relied on the taxpayer's argument in *Gentile* for support. The court, after reconsidering the *Gentile* test, found it to be overly restrictive.

The *Gentile* court had cited *Snow v. Commissioner*²⁹ as a Supreme Court endorsement of the "holding one's self out" test. But the *Ditunno* court rejected the *Gentile* court's interpretation, stating that *Snow* neither affirmed nor adopted Justice Frankfurter's "goods and services" test. Instead, the court reasoned that the *Snow* opinion quoted Justice Frankfurter's language simply for comparative purposes. "[T]he *Snow* reference to Justice Frankfurter's concurrence in *Deputy v. DuPont* [sic] does not indicate that the Supreme Court intended to reconsider *Higgins* or to approve his definition."³⁰ The test promulgated by the *Ditunno* court in determining whether an individual is engaged in a trade or business is the same that was used in the *Higgins* decision, where the Court required an examination of all of the facts and circumstances in each case.³¹

In applying the "facts and circumstances" test to *Ditunno's* gambling activities, the court concluded that he was in the trade or business of gambling within the meaning of section 62(1). The court noted that *Ditunno* was not a passive investor managing a securities or real estate portfolio as was the taxpayer in *Higgins*. He was, instead, an active gambler, devoting his full time to gambling activities.

Chief Judge Tannenwald, who authored the *Gentile* opinion, dissented. He suggested that the majority opinion would "wreak havoc" on the concept of trade or business which had been developed over time through the judicial process. In overruling the *Gentile* "holding one's self out" test, Judge Tannenwald accused the majority of ignoring both the nature of the "facts and circumstances" test and a long-accumulated body of case law. In his view

27. *Ditunno*, [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2858. The Service argued that the gambling loss deductions were not deductible under § 62 and thus constituted items of tax preference which would result in the imposition of the alternative minimum tax of § 55.

28. *Id.*

29. 416 U.S. 500 (1974).

30. *Ditunno*, [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2862.

31. *Id.* at 2859-60.

"holding one's self out" was an essential but not necessarily controlling ingredient to support a finding of carrying on a trade or business. Judge Tannenwald disagreed with the majority's interpretation that *Snow* does not indicate approval of Justice Frankfurter's definition. Conceding that the Supreme Court used Justice Frankfurter's "holding one's self out" definition for comparative purposes, Judge Tannenwald said:

[T]he fact of the matter is that the Court found it necessary to select a standard for comparing section 162 [itemized trade or business deductions] with section 174 [itemized research and experimental deductions—the section *Snow* was concerned with] and, in so doing, selected Justice Frankfurter's holding-out test. If this does not constitute approval, I do not know what does.³²

The day following the *Ditunno* decision, a memorandum decision filed in the case of *Estate of Cull v. Commissioner*³³ seemingly enlarged the class of taxpayers subject to the trade or business tax provisions. Written by Judge Sterrett,³⁴ the opinion was based on a factual situation similar to that of *Ditunno*. However, the petitioner in *Cull*, in addition to being an extensive gambler, was also employed full-time as a pari-mutuel clerk at various racetracks. When not working at his job, he gathered information for purposes of placing wagers which he made on an almost daily basis. In challenging Cull's loss deductions, the Service made no attempt to contradict the taxpayer's position that he was a professional gambler who devoted substantial time and energy to gambling. Instead, it relied on the *Gentile* "holding one's self out" test.³⁵ Rejecting that test, the court cited *Ditunno* and said that in determining whether a gambler was in the trade or business, one must look "to the character of his gambling activities [to find if they are] sufficiently 'active' to elevate them to trade or business status."³⁶ Due to the uncontradicted testimony, the court held that the petitioner was in the separate trade or business of gambling.³⁷

In a footnote, the court referred to *Murphey v. Commissioner*,³⁸ for the proposition that a taxpayer may be engaged in more than

32. *Id.* at 2865 (Tannenwald, C.J., dissenting) (footnote omitted).

33. 45 T.C.M. (CCH) 691 (1983).

34. Judge Sterrett had joined Chief Judge Tannenwald's dissenting opinion in *Ditunno*.

35. *Cull*, 45 T.C.M. at 692-93.

36. *Id.* at 692.

37. *Id.*

38. 73 T.C. 766 (1980).

one trade or business. In doing so, *Cull* seems to implicitly extend the ambit of the trade or business classification further than that delineated in *Ditunno*. *Ditunno* was a full-time gambler having no other profession or employment. The *Ditunno* opinion stated: "In sum, petitioner was an active gambler, devoting his *full time* to gambling activities."³⁹ By contrast, the petitioner in *Cull* was employed full-time as a pari-mutuel clerk. Outside of \$129 in interest and dividend payments, *Cull* was paid \$20,963 for his employment services during the year in question.⁴⁰ Despite his full-time job as a clerk, *Cull* was also found to be in the trade or business of gambling. This would seem to open the door to others who actively pursue the games of chance, not on a full-time basis, but enough to reach the phantom trade or business status.⁴¹

Having given a brief overview of the evolution of the term "trade or business," the remainder of this comment will focus on the use of trade or business in two areas which often give rise to litigation: that of the *Higgins*-type personal investor and that of the promoter, developer, or financier of business enterprises. Although the propositions that have developed in either context do not appear difficult to apply, judicial decisions based on the "facts and circumstances" test reveal a wide array of activities which may rise to the level of trade or business.⁴² The diverse holdings have prompted at least one commentator to call for a uniform definition of the phrase where it is not used in any special context.⁴³

The lack of clear criteria has led some courts to find, in some instances,⁴⁴ that taxpayers who do make advances to their closely-held corporations are, in fact, engaged in a trade or business. Similarly, despite the *Higgins* decision's admonition that, no matter how large the estate or how much time one devotes to managing it, personal investment activity is not a trade or business, different courts have applied the "facts and circumstances" test to arrive at the conclusion that such activity can be a trade or business. After a

39. *Ditunno*, [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2863 (emphasis added).

40. *Cull*, 45 T.C.M. at 691.

41. See *Gajewski v. Comm'r*, 45 T.C.M. (CCH) 967 (1983) (Judge Tannenwald finds gambler to be in the trade or business of gambling without making reference to the amount of time the taxpayer devoted to his trade).

42. See *Saunders*, *supra* note 1, at 726.

43. See *Roth*, *supra* note 3, at 39.

44. Different courts seem to apply their own version of the "facts and circumstances" test.

taxpayer devotes enough time⁴⁵ to the management of his investments, he is no longer an investor but instead becomes a securities trader. Such status is achieved even though he buys and sells for no one but himself. Achieving the trader status is tantamount to grasping the brass ring, for it allows one to take trade or business deductions.

The dissenting opinion in *Ditunno* predicted "havoc" would result from the demise of the "holding one's self out" test.⁴⁶ While perhaps an overly pessimistic view, it cannot be doubted that fewer fixed criteria and extensive reliance on the subjective "facts and circumstances" test will inevitably lead to headaches for the tax planner. Certainly, the Service's view of the "facts and circumstances" will differ greatly from that of the taxpayers. With the burden of proof being on the taxpayer,⁴⁷ the likelihood of a challenge from the Service over trade or business deductions seems greater.

III. PERSONAL INVESTMENT ACTIVITY

A. *Investors: No Trade or Business*

The starting point of a discussion of trade or business in the context of personal investments must begin with *Higgins*. As discussed previously, the *Higgins* Court agreed with the Service that no amount of personal investment activity could rise to the level of trade or business.⁴⁸ Of greater importance, the Court formulated the "facts and circumstances" test to determine whether a taxpayer's activities constitute a trade or business. Oddly enough, some courts have used the *Higgins* test to reach the conclusion that personal investment activity does rise to the trade or business level.

An example of strict adherence to the *Higgins* rationale is the Ninth Circuit's opinion in *Purvis v. Commissioner*.⁴⁹ Additionally, *Purvis* highlights the judicial distinction which has evolved between the securities investor and the securities trader. The petitioner in *Purvis* sought to be classified as a trader in securities,

45. Once again, the answer to the question of what constitutes sufficient time varies among courts.

46. *Ditunno*, [Current Decisions] TAX CT. REP. (CCH) No. 39,888, at 2864 (Tannenwald, C.J., dissenting).

47. See U.S. TAX CT. R. PRAC. & PROC. 142(a).

48. See *supra* note 18 and accompanying text.

49. 530 F.2d 1332 (9th Cir. 1976).

agreeing with the Commissioner that if he were classified as an investor and not a trader he would not meet the trade or business requirement. The court, citing the *Higgins* passage⁵⁰ and the comment in *Whipple v. Commissioner*,⁵¹ agreed that no amount of investment activity can rise to the level of trade or business. Drawing a distinction between a securities trader and a securities investor,⁵² the court concluded that the petitioner was not a trader. As a basis for its decision, the court noted that from 1963 to 1968 the petitioner engaged in only seventy-five security sales, of which thirty-one involved stocks held for more than six months.⁵³ The petitioner visited brokers on the average of three or four days a week and had listed his occupation as an attorney on his tax returns. Following the rigid approach of *Higgins*, the court determined that he was merely an investor, and thus his activities in purchasing and selling stock did not meet the trade or business requirement.⁵⁴ This court followed *Higgins* in holding that an investor does not qualify as being in a trade or business.⁵⁵

Three cases decided on the "facts and circumstances" test are *Commissioner v. Nubar*,⁵⁶ *Adda v. Commissioner*,⁵⁷ and *Chang Hsiao Liang v. Commissioner*.⁵⁸ Although two of these cases produced results dissimilar from *Higgins*, all three involved decisions under section 211 of the Internal Revenue Code of 1939.⁵⁹ *Adda* and *Nubar* will be discussed in the next section, where cases involving taxpayers who have been found to be in a trade or business are discussed.

The section 211 case in which the Tax Court determined that a taxpayer was not engaged in a trade or business is *Liang*. The petitioner in that case was a nonresident alien residing in China who

50. See *supra* note 18 and accompanying text.

51. 373 U.S. 193, 202 (1963). See *infra* notes 90-91 and accompanying text.

52. *Id.* An investor purchases securities for capital appreciation and income, usually without regard to short-term changes on the daily market. A trader, on the other hand, purchases and sells securities with reasonable frequency in order to catch the swings in the daily market to profit on a short term basis. See *Chang Hsiao Liang v. Comm'r*, 23 T.C. 1040, 1043 (1955).

53. *Purvis*, 530 F.2d at 1334.

54. *Id.*

55. See *supra* note 18 and accompanying text.

56. 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).

57. 10 T.C. 273 (1948).

58. 23 T.C. 1040 (1955).

59. Currently I.R.C. § 871 (CCH 1983). This section provides for the taxation of nonresident alien individuals engaged in a trade or business within the United States. Under the 1939 Code, the phrase "engaged in a trade or business within the United States" did not include transactions in commodities, stocks, or securities effected through a resident broker.

left the management of his considerable account to the sole discretion of his United States agent. The Tax Court held that the absence of frequent short-term turnover in the portfolio led to the conclusion that the securities sold were merely part of an investment activity and did not rise to the level of a trading operation.⁶⁰ The court cited the extensive transactions in *Adda* and *Nubar* as being quite different from the facts in *Liang*. Looking over a seven-year span, the court determined that the petitioner's primary objective was to establish an investment account in order to ensure a reliable source of income. Thus, the activity did not rise to the level of being a trade or business and the Service's deficiency determination was erroneous.⁶¹

The issue was recently addressed again in *Skoglund v. United States*.⁶² There the plaintiff sought to deduct above the line her expenses associated with her investment activity.⁶³ Skoglund claimed that she spent approximately fifteen hours a week on her investment activities, and this management activity brought her within the ambit of carrying on a trade or business. She also argued that she was entitled to the deduction because "common sense would indicate that taxpayers should be able to reduce income directly through the deduction of related expenses."⁶⁴ Like the taxpayer in *Wilson*, Skoglund chose to litigate the issue in the Court of Claims.

60. *Liang*, 23 T.C. at 1042.

61. *Id.* at 1045. The importance of the term "trade or business" is evident in the field of estate management as well. Such was the case in *White's Will v. Comm'r*, 119 F.2d 619 (3d Cir. 1940). In that case, the petitioners were trustees of a large estate, the principal asset being capital stock of the Health Products Corporation. The petitioners sought to deduct the cost of certain legal proceedings, claiming they were incurred as business expenses in the trade or business of managing the estate. The Commissioner determined that the management of a trust estate did not constitute a trade or business. *Id.* at 620. On appeal to the Third Circuit, the court determined that the investing and reinvesting of assets, either by an individual for himself or by a trustee on behalf of an estate, does not constitute a trade or business. Quoting Judge Learned Hand's opinion in *Bedell v. Comm'r*, 30 F.2d 622 (2d Cir. 1929), the court stated: "Most men who have capital change their investments, and may speculate all the time; we should hardly call this a business, though the line is undoubtedly hard to draw." 119 F.2d at 621. Thus, the court reasoned, even though the trustees were required to manage the estate on a daily basis, their situation is analagous to that of an investor who keeps an eye on the stock market and other investment opportunities. *Id.* at 622-23.

62. 82-1 U.S. Tax Cas. (CCH) ¶ 9270, at 83,609 (Ct. Cl. 1982).

63. *Id.* The plaintiff originally claimed the deduction as an itemized deduction. However, she amended her return to take the deduction above the line in arriving at her adjusted gross income. *Id.* This was done because her zero-bracket amount was larger than her other itemized deductions.

64. *Id.* at 83,610.

The court rejected both arguments. Citing *Whipple*, the court noted that it is difficult for an individual's investment activity to rise to a level that constitutes a trade or business. The court ruled as a matter of law that her fifteen hours a week of labor does not rise to that level. As to the plaintiff's common sense argument, the court said: "Unfortunately, common sense and tax law are rarely even waving acquaintances."⁶⁵

Perhaps the best taxpayer argument may be found in the recent case of *Cleveland v. Commissioner*.⁶⁶ Between January and May, 1961, the petitioner in *Cleveland* traded in commodity futures for his own account. On February 28, 1961, he purchased a seat on the Chicago Board of Trade. He also established a margin account with a brokerage firm which cleared his trades for him. By clearing the trades, the firm acted as a surety and guaranteed that the petitioner would fulfill all of his obligations. On June 7, 1961, the brokerage firm sold his futures and closed his commodity account, resulting in a \$57,000 loss to the petitioner. The firm paid the Chicago Board of Trade on behalf of the petitioner, but the petitioner failed to repay his debt to the firm. Eventually the firm sued him and in 1964 the suit was settled for \$8,004, which the petitioner paid. On his 1964 return he took a \$7,500 ordinary loss deduction, allegedly based on this transaction.⁶⁷

After the petitioner was indicted and pled guilty to tax evasion charges, the Commissioner determined that the futures sold by the petitioner were capital assets, thus resulting in short-term capital loss treatment. The petitioner argued that they were ordinary in nature since he was engaged in the trade or business of commodity trading. The Tax Court, relegating the decision to a memorandum opinion, first recharacterized the \$8,000 as a loss, noting that the petitioner accumulated \$57,000 worth of commodity losses in 1961 and should have reported them in that year. The settlement of the suit for \$8,000 in 1964 was a separate transaction which arose not from the 1961 losses, but rather from the petitioner's liability to his brokerage firm.⁶⁸

Citing *Ditunno* and *Higgins*, the court looked to the facts. In 1961, the petitioner became a member of the Chicago Board of Trade and made approximately eighty commodity transactions. During that year, in addition to buying his seat on the Chicago

65. *Id.*

66. [Current Decisions] TAX CT. MEM. DEC. (CCH) (46 T.C.M.) 257 (May 26, 1983).

67. *Id.*

68. *Id.*

Board of Trade, the petitioner also sold it. He did not report any gains or losses from the trade or business of commodity trading in 1961. The settlement deduction was reported as a settlement of a claim against the petitioner. Finally, he failed to keep separate books and records. The court said: "Viewing these facts together, we can only conclude that petitioner engaged in commodity futures trading as a form of personal investment."⁶⁹ In light of these facts, the court determined that the petitioner had not met his burden of proving that he was in the separate trade or business of commodity trading.⁷⁰

In summary, the recent judicial trend has been to avoid making a determination of trade or business. This trend is consonant with the tax maxim that deductions are a matter of legislative grace and therefore should be strictly construed.⁷¹ However, the matter is not an open and shut case. As the next section demonstrates, some courts take the view that certain investment activities do in fact rise to the level of a trade or business.

B. Traders: Trade or Business

The earliest of the three section 211 (1939 Code) cases previously mentioned is *Adda*, which involved an Egyptian citizen residing in German-occupied France. Due to the war, the petitioner was cut off from communications and relied on the sole discretion of his brother, a United States resident, to manage his investment portfolio.⁷² The Tax Court found the petitioner to be engaged in a trade or business. Looking at the facts of the case, the court determined that the petitioner's activities constituted trading in securities. While neither the number of transactions nor the total amount of money involved was stated, the court pointed to numerous "transactions [being] effected, . . . several accounts . . . maintained, and gains and losses in substantial amounts . . . realized."⁷³ It is unclear how the facts and circumstances of *Adda* are sufficiently dissimilar from those in *Higgins*, where the taxpayer had "extensive investments," "devoted a considerable portion of his time" to them, and "hired others to assist him in offices rented for that purpose."⁷⁴ However, in *Adda*, the court determined that

69. *Id.* at 279.

70. *Id.*

71. *du Pont*, 308 U.S. at 493.

72. *Adda*, 10 T.C. at 275.

73. *Id.* at 277.

74. See *supra* note 14 and accompanying text.

the petitioner's activities through his brother-agent had risen above the mere investor class into the trader status, thus qualifying him as being in the trade or business. As exemplified by these decisions, the "facts and circumstances" test is clearly a subjective one which renders an uncertain result.

The final section 211 case is *Nubar*. The uncertainty of the "facts and circumstances" test is underscored by the two opinions issued in that case. The first was the Tax Court's 1949 opinion, *Nubar v. Commissioner*.⁷⁵ The petitioner in *Nubar*, like the petitioner in *Adda*, was a wealthy Egyptian. For the three years in question, the taxpayer reported capital gains of \$62,795, \$229,224, and \$209,823.⁷⁶ The taxpayer reported capital gains from trading in commodities futures of \$62,795, \$2,775, and \$1,660. He also reported dividend and interest income of \$34,120, \$72,084, and \$100,536. In 1945, he stated the value of his securities to be \$2,496,952 and his liabilities to be \$721,423.⁷⁷

The Tax Court determined that the petitioner's activities fell within the statutory exclusion of section 211, and thus did not achieve trade or business status.⁷⁸ The court distinguished *Adda* by noting that that decision was based on the fact that *Adda* had engaged, through his agent-brother, in business in the United States, while all of the transactions in *Nubar* were carried on through a resident broker in conformity with the statute. The Fourth Circuit reversed.⁷⁹ Recounting the findings of the Tax Court of the large value of securities and commodities trading engaged in by *Nubar*,⁸⁰ the court found the Tax Court's conclusion "clearly erroneous, whether regarded as a conclusion of fact or as a conclusion of law."⁸¹ The court determined that he was *not* a non-resident alien within the meaning of the statutory exclusion and that he *was* engaged in a trade or business.

75. *Nubar v. Comm'r*, 13 T.C. 566 (1949).

76. These gains were reported for the years 1941, 1943, and 1944—the three years in which deficiencies were determined. *Id.* at 573.

77. *Id.* at 573-74.

78. The initial hurdle the court had to clear was classifying the petitioner as a nonresident alien since he lived in the United States from 1939-45. The court considered the facts and determined that his intention was not to become a United States resident. Mexico denied his visa application four times; France told him he could not return; Spain and Portugal would not issue visas; and war-time conditions made his return to Egypt or Switzerland either hazardous or impossible. *Id.* at 570-76.

79. *Nubar v. Comm'r*, 185 F.2d 584 (4th Cir. 1950).

80. See *supra* notes 75-78 and accompanying text.

81. *Nubar*, 185 F.2d at 586.

There can be no question but that the extensive trading in stocks and commodities constituted engaging in trade or business within the meaning of the statute. . . . *Higgins* . . . is not to the contrary. . . . *Nothing was said to indicate that such extensive trading as was disclosed here would not constitute doing business*, and the [*Higgins*] Court pointed out that whether the activities of a taxpayer constitute "carrying on a business" requires an examination of the facts in each case.⁸³

The court obviously chose to ignore *Higgins'* admonition that such activity, no matter how large or continuous, does not rise to the level of a trade or business.⁸³ Instead, the court relied on the extensive trading involved.⁸⁴ Evidently the Fourth Circuit viewed the facts and circumstances in a different light than that of the Tax Court.

A recent decision from the United States Court of Claims again emphasizes the unpredictability of the "facts and circumstances" test. In *Moller v. United States*,⁸⁵ the plaintiffs, a married couple, managed four portfolios of securities.⁸⁶ The Mollers, like Mr. Higgins, maintained two offices to conduct their securities management, and sought to deduct the cost as an ordinary and necessary business expense. The Service disallowed the deductions, contending that the Mollers were not carrying on a trade or business. The Court of Claims held for the plaintiffs. The court stressed that the plaintiffs devoted between forty and forty-two hours per week to their investment activities, subscribed to the Wall Street Journal, studied corporate financial reports, made numerous securities transactions, and thus determined that the plaintiffs were carrying

82. *Id.* at 588 (emphasis supplied).

83. *See supra* note 18 and accompanying text.

84. A comparison of the transactions engaged in by Higgins and Nubar shows that value-wise their deals were not substantially different. Higgins purchased \$675,000 worth of securities in 1932. *Higgins v. Comm'r*, 39 B.T.A. 1005, 1008 (1939). In 1941, the total value of Nubar's purchases and sales only rose to \$664,896. *Nubar*, 13 T.C. at 572. In 1933, Higgins purchased bonds in the amount of \$1,052,000. *Higgins*, 39 B.T.A. at 1008. In 1943 and 1944, Nubar purchased and sold securities in the amounts of \$2,389,743 and \$2,179,549, respectively. *Nubar*, 13 T.C. at 572. Higgins held securities valued at \$16,453,000 and \$17,278 in the years 1932 and 1933, respectively. *Higgins*, 39 B.T.A. at 1008. Nubar held securities valued at \$2,496,952 in 1945. *Nubar*, 13 T.C. at 572.

85. 553 F. Supp. 1071 (Ct. Cl. 1982).

86. One of the portfolios consisted of securities held by the husband, one held by the wife, one held in trust from which the husband received income, and one held in trust from which the wife received income. *Id.* at 1072. Thus, the management of the portfolios was for the personal benefit of the plaintiffs.

on a business.⁸⁷

The court explained the Supreme Court's comment in *Whipple* that "investing is not a trade or business" by saying that the statement should be considered in context. Since the petitioner in *Whipple* did not manage a portfolio, the court felt the cases could be distinguished. The court then went on to distinguish *Higgins* by saying that Higgins' activities "were not at all comparable to the regular, extensive, and continuous activities of the plaintiffs in this case."⁸⁸ However, according to the facts, Higgins had engaged in regular, extensive, and continuous activity in the management of his portfolio. Nevertheless, the *Higgins* Court stated: "No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board [that this activity does not constitute a trade or business]."⁸⁹ How the facts and circumstances of *Higgins* are "readily distinguishable" from the facts and circumstances of *Moller* is, at the very least, questionable.

IV. THE CORPORATE PROMOTER

Section 166 of the Code,⁹⁰ pertaining to the deductibility of bad debts, is another area where the status of trade or business is of vital importance to the taxpayer. Problems arise in this area when the bad debt belongs to the taxpayer's closely-held corporation. The general rule is that unless a taxpayer is engaged in an extensive lending business, it is very difficult for a taxpayer to qualify his bad debts as business bad debts. Normally, it takes extensive and continuous activities for a debtor to prove that his promotional and lending activities are sufficient to be classified as a trade

87. *Id.* at 1073-75.

88. *Id.* at 1077.

89. *Higgins*, 312 U.S. at 478.

90. I.R.C. § 166 (CCH 1983) provides in pertinent part:

(a)(1) Wholly worthless debts—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(d)(1) General rule—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt. . . .

(2) Nonbusiness debt defined—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

or business. Once again, the question is one of fact.⁹¹ As was the case with the securities investor, judicial opinion differs as to what facts can raise a shareholder's lending activities to the level of trade or business.

A. *Lending Activity: No Trade or Business*

The issue of what constitutes a "trade or business" in the context of lending activity is not new to the tax laws. Perhaps the leading case in this area is the United States Supreme Court opinion of *Whipple v. Commissioner*.⁹² The issue in *Whipple* centered around the deductibility of loans which were made to a corporation owned substantially by the taxpayer and which later went bad. The taxpayer sought to justify the deductions by claiming, in the alternative, that he was in the trade or business of organizing, promoting, managing, and financing corporations, or general financing and lending of money, or operating a bottling business, or all three.⁹³

The Court, upholding the Commissioner, stated that devoting one's time and energy to a corporation is not in and of itself a trade or business. While this activity may produce income, the return is characteristic of the process of investing as distinguished from the trade or business of the taxpayer himself. When the return is only that of an investor, the taxpayer has not demonstrated that he is engaged in a trade or business because *investing is not a trade or business*.⁹⁴ Further, the Court reasoned that since the taxpayer did not dispute the fact that there was no intention of developing corporations as ongoing businesses for sale, the dispositive issue was whether one who actively serves his own corporation for future income is in a trade or business. The Court found this argument untenable in light of *Higgins*, stating that "[a]bsent substantial additional evidence, furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business."⁹⁵

Although decided prior to *Whipple*, the case of *Putnam v. Commissioner*⁹⁶ exemplifies the *Higgins* premise. The taxpayer in *Putnam* was a lawyer who entered into a venture to publish a labor

91. See *infra* note 137 and accompanying text.

92. 373 U.S. 193 (1963).

93. *Whipple v. Comm'r*, 19 T.C.M. (CCH) 187, 191 (1960).

94. *Whipple*, 373 U.S. at 202 (emphasis supplied).

95. *Id.* at 203.

96. 352 U.S. 82 (1956).

newspaper. Putnam supplied the start-up corporate costs and also made cash advances to the new corporation. Putnam also guaranteed two notes given by the corporation to a bank.⁹⁷ The corporation was unsuccessful and Putnam ended up discharging the corporate debts. Putnam deducted the amounts as a loss incurred in a transaction for profit, though not connected with a trade or business under section 23(e)(2) of the 1939 Code.⁹⁸ The Commissioner disallowed the deduction and determined that the loss was a non-business bad debt, resulting in short term capital loss treatment under section 23(k) of the 1939 Code.⁹⁹

On appeal, the United States Supreme Court accepted the Commissioner's argument that the loss was a nonbusiness bad debt. Implicitly acknowledging that one is not in a trade or business by virtue of making loans to one's own corporation, the Court said: "There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan."¹⁰⁰ Courts, in applying this principle, usually consider loans made by a taxpayer as investments and, following the *Higgins* decision, find that such lending activities do not constitute a trade or business.¹⁰¹

Like the taxpayer in *Putnam*, the petitioner in *Rollins v. Commissioner*¹⁰² was a lawyer who participated in a variety of business ventures. In 1950, the taxpayer advanced \$20,000 to one of his business concerns, which became worthless in 1952, and, from 1947 through 1953, advanced a total of over \$110,000 to another of his enterprises, which also became worthless.¹⁰³ In addition to his law practice, the petitioner also was actively engaged as an insurance investigator and adjustor, and over a thirty-year period participated in twenty-two business ventures. He deducted the full amount of his losses as business bad debts, asserting that he was in the business of "promoting, organizing, financing, managing, and making loans to business enterprises."¹⁰⁴

The court stated that in only a limited number of instances have

97. *Id.* at 85.

98. Currently I.R.C. § 165(c)(2) (CCH 1983).

99. Currently I.R.C. § 166(a) (CCH 1983).

100. *Putnam*, 352 U.S. at 92-93.

101. See Saunders, *supra* note 1, at 726.

102. 32 T.C. 604 (1959).

103. Perhaps Rollins should have been aware of the potential for failure since his advances were used to finance the production of "bean nippers" and "tomato skinners." *Id.* at 608.

104. *Id.* at 612.

promotional and lending activities been sufficiently extensive and continuous to rise to the level of being a trade or business. Quoting *Berwind v. Commissioner*,¹⁰⁵ an earlier Tax Court opinion, the court said:

The authority . . . [of such "promoter" or "lender" cases] is applicable only to the exceptional situations where the taxpayer's activities in promoting, financing, managing, and making loans to a number of corporations have been regarded as so extensive as to constitute a business separate and distinct from the business carried on by the corporations themselves.¹⁰⁶

Despite the twenty-two business activities over a thirty-year period, the court felt that the petitioner had not met the burden of proving that he was in the business of promoting corporations. The court pointed out that many of his advances to his corporations were simply bank endorsements or guarantees of corporate loans. However, this has not proven a problem in other cases in which the separate business of corporate promotion has been found.¹⁰⁷ Also, the court pointed out that many of the advances were to thinly capitalized enterprises and *may* have been capital contributions instead of genuine loans. Further, the court noted the absence of any evidence of indebtedness, another area other courts have not found troublesome.¹⁰⁸

In sum, the court felt that Rollins was motivated more by his interest as an investor than as an independent promoter. Citing *Higgins* for support, the court said: "It is now well settled that activity involving the protection or enhancement of one's investments, or otherwise involving their management, however extensive or time consuming, does not constitute a separate trade or business."¹⁰⁹

Perhaps not so compelling a set of facts as was found in *Rollins* surfaced in the Ninth Circuit's opinion *Holtz v. Commissioner*.¹¹⁰ The petitioner in *Holtz* had deducted certain corporate debts which he had guaranteed. He claimed them as business bad debts while the Commissioner asserted them to be nonbusiness bad debts. The court said that "[t]o determine whether the loss was

105. 20 T.C. 808 (1953).

106. *Rollins*, 32 T.C. at 613.

107. *Id.*

108. *Id.*

109. *Id.* at 615.

110. 256 F.2d 865 (9th Cir. 1958).

incurred in the petitioner's trade or business requires a definition of the taxpayer's business."¹¹¹ This, according to the court, "is a mixed question of law and fact."¹¹²

The petitioner was the substantial owner of a retail apparel store. Prior to the corporation's failure it had obtained extensive loans which the petitioner had guaranteed. He was also involved in three other corporations relating to the selling and distribution of film, supplies and equipment, and motion picture equipment.¹¹³ One of these corporations obtained working capital from a bank loan which was personally guaranteed by the petitioner. Eventually, the corporation filed for bankruptcy and was dissolved. The bank sold the corporation's collateral securities,¹¹⁴ realizing over \$83,000 on the sale.¹¹⁵ This amount was claimed as a bad debt loss incurred in a trade or business which would yield a net operating loss carryback.¹¹⁶ The Tax Court determined that the petitioner's activities were not sufficiently extensive to establish the existence of a separate business of promoting, organizing, financing and managing businesses.¹¹⁷

On appeal, the petitioner argued that the decision of the Tax Court was clearly erroneous in that his activities fell within the case law holding that one who finances, organizes or promotes corporations is entitled to a business bad debt deduction. He had participated, either as a lender or guarantor, in approximately 250 loans to his four corporations. The court distinguished the case of *Giblin v. Commissioner*¹¹⁸ by saying that the taxpayer in *Giblin* was in the business of promoting, organizing and financing businesses to which he contributed fifty percent of his time. According to the Ninth Circuit, this was not the case with Holtz. The court agreed with Holtz that *Giblin* should not be distinguished simply because the petitioner in *Giblin* was involved with more corporations. However, the court felt that Holtz's activities did not rise to the level of a trade or business. Clearly, courts are left with broad discretion in making this determination.

111. *Id.* at 867.

112. *Id.*

113. *Id.*

114. The petitioner had pledged as collateral certain shares of stock valued in excess of the amount of the loan. *Id.*

115. Holtz was still indebted on his guaranty in excess of \$64,000 after the sale. *Id.*

116. The petitioner had already recovered the refund. The Commissioner sought the return of this amount as a refund illegally paid.

117. *Holtz v. Comm'r*, 16 T.C.M. (CCH) 439 (1957).

118. 227 F.2d 692 (5th Cir. 1955). See *infra* notes 138-43 and accompanying text.

The Ninth Circuit revisited the issue in *United States v. Keeler*.¹¹⁹ The taxpayer, already engaged in the industrial laundry business in Seattle, formed a corporation with three others to start another laundry business in Canada. The three encouraged a number of persons to purchase stock and debentures of the new corporation by promising to reimburse them for any losses which might occur as a result of their investment. The new corporation was financially unsuccessful from the beginning. The taxpayer made cash and credit advances totaling over \$132,000 to bolster the sagging enterprise. Nevertheless the fortunes of the new corporation continued on a downward slide. Ultimately, the taxpayer was able to recoup only \$44,000 of the \$132,000 he had advanced to the business, leaving over \$88,000 which he deducted as a business bad debt under section 166.¹²⁰

The district court allowed the \$88,000 deduction as a business debt. The court stated:

[A]ny reasonable person viewing this factual situation could come to only one logical conclusion, that [the taxpayer] . . . joined an enterprise which if successfully developed, would become and benefit [his] regular course of business; that [he] entered into this joint venture for the purpose of developing an enterprise that was incidental to and in relation to his business, that of the industrial laundry business. . . . So, I come to the *inescapable* conclusion that this whole transaction entered into by this tax payer [sic] was nothing more than for the benefit of, incidental to, and in relation to his business, that of [the industrial laundry business] here in Seattle.¹²¹

Reviewing the district court's decision, the Ninth Circuit relied on the "facts and circumstances" test of *Higgins* to provide the appropriate analytical framework. The government, in support of its contention that the taxpayer's loans were not business loans, relied on *O'Neill v. Commissioner*.¹²² The *O'Neill* court said that a taxpayer who makes loans to his corporation can qualify for a business loss deduction only "(1) where he is in the business of loaning money, or (2) he is in the business of promoting, financing and managing business enterprises."¹²³ The government conceded that

119. 308 F.2d 424 (9th Cir. 1962).

120. *Id.* at 425-27.

121. *Id.* at 427 n.3 (emphasis supplied). The district court decision was unreported.

122. 271 F.2d 44 (9th Cir. 1959).

123. *Id.* at 48.

the *O'Neill* rule is not always dispositive and that "if the loans bear a sufficiently direct relationship to the taxpayers' trade or business, the loan can be a business debt even though the taxpayer is not in the business of loaning money or promoting business enterprises."¹²⁴

The district court found that the taxpayer had advanced money to the new corporation "to aid and to nurture and to build up his going business here in Seattle."¹²⁵ On appeal, the Ninth Circuit stated that the facts revealed some of the anticipated benefits were more "fanciful than real." In short, the court held the loans were not sufficiently related to his Seattle business to warrant deduction as a business bad debt. Evidently, the district court's *inescapable* factual conclusion was clearly erroneous.

Two recent pronouncements demonstrate the proclivity which still exists for the denial of trade or business status. *Benak v. Commissioner*¹²⁶ was decided by the Tax Court in 1981. *Benak* involved the usual scenario of a corporate loan gone bad coupled with the petitioner-guarantor making good on his corporate bank loan. The petitioner deducted the amount as a business bad debt under section 166, claiming he was in the business of making investments in small businesses. The court determined the petitioner's principal business was that of an employee of his corporation. Recognizing that one may be in more than one trade or business, the court held that the petitioner failed to prove he was in the investment business. He testified he had made six loans to other small businesses, but could not substantiate the loans. According to the court, the petitioner "utterly failed to prove that their dominant motivation for guaranteeing the [corporate] loan . . . was a part of carrying on an investment business."¹²⁷

The second recent Tax Court decision is *Deely v. Commissioner*.¹²⁸ The petitioner in *Deeley* became financially involved in approximately thirty business entities over a twenty-five-year period. In addition to providing part of the initial capital, he contributed services and his expertise. He also assisted them in obtaining financing either by personal loans or by acting as a guarantor of

124. *Keeler*, 308 F.2d at 429.

125. *Id.* at 429 n.3.

126. 77 T.C. 1213 (1981).

127. *Id.* at 1217. Compare *Deely v. Comm'r*, 73 T.C. 1081 (1980), where the court said: "It is equally clear that if the shareholder is only an investor, the same debt will be classified as a nonbusiness bad debt. . . ." 73 T.C. at 1092.

128. 73 T.C. 1081 (1980).

their promissory notes.¹²⁹ The petitioner invested over \$750,000 and had loaned over \$2.25 million to his various businesses. In addition to his extensive investments in these enterprises, he similarly made large investments as a passive investor in companies in which he had no direct involvement.

In 1967, the petitioner formed a computer corporation with the stated purpose of making it attractive for a merger and eventual sale to the public.¹³⁰ Pursuant to this plan, he guaranteed two notes totaling \$180,000 and loaned the corporation \$63,750. Before the corporation's insolvency, all but approximately \$35,715 due on the notes and \$18,067 due on the loan had been repaid. The petitioner claimed these two amounts as a business bad debt.

From 1968 through 1974 the petitioner listed on his tax returns his occupation as an oil operator, investor and inventor. When notified that his returns were under examination, his accountant submitted a letter to the Service stating that the petitioner was in the business of lending money and being an employee.¹³¹

The court, citing *Higgins*, said that the issue of whether a debt is incurred in a trade or business is a question of fact. The court recognized that a worthless debt may qualify as a business debt if the person is in the business of promoting and selling businesses.¹³² The court, in holding that the petitioner had not established a separate business, stated that *Whipple* was dispositive. The petitioner did not show that the compensation he sought was other than the normal investor's return. According to the court, *Whipple* requires that one's activities "must be conducted for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business."¹³³

The petitioner never received any fees or commissions for his promotional activities. Instead, he usually took equity interests in his business enterprises. However, under the authority of *Giblin v. Commissioner*,¹³⁴ the petitioner maintained that he was in the trade or business of developing business entities for eventual resale.

129. *Id.* at 1084-85.

130. *Id.* at 1086.

131. *Id.* at 1087-88.

132. The court also cited *Higgins* for the proposition that if the shareholder is only an investor, the same debt will be classified "as a nonbusiness bad debt, for management of one's investments, no matter how extensive, does not constitute a trade or business." *Id.* at 1092.

133. *Id.* at 1093. This seems to be a very restrictive reading of *Whipple*.

134. 227 F.2d 692 (5th Cir. 1955).

The court said that in order to fall within the rule established in *Giblin*, the petitioner must show "that the entities were organized with a view to a quick and profitable sale after each business had become established, rather than with a view to long-range investment gains."¹³⁵ According to the court, the longer the period of time an interest is held, the more the profit is attributable to the successful operation of the corporate business. Looking to the facts to determine if Deeley met the *Giblin* standard, the court focused on twenty-six of the business entities. Eleven entities were quickly sold or abandoned.¹³⁶ Sixteen were at least marginally profitable.¹³⁷ With regard to the sixteen, the court was able to ascertain the length of time the petitioner maintained an interest in fourteen of them. Seven of the fourteen were held for periods longer than thirteen years and seven were held for periods of less than six years.¹³⁸

According to the court, it was apparent that the petitioner's activities demonstrated an initial intent to hold onto the profitable ventures and dispose of the unprofitable ventures.¹³⁹ The length of time the petitioner held these profitable entities was fatal to his claim that he was in the trade or business.

B. Lending Activity: Trade or Business

As was the case with taxpayers engaged in personal investment activity, certain corporate shareholders have been held to be in a trade or business with respect to their closely-held corporations. According to some courts, a taxpayer's loans to his corporation when combined with extensive promotional activities may result in a finding that the taxpayer is in the trade or business of promoting or financing corporations. Treasury regulations reflect that the "facts and circumstances" test provides the appropriate analytical framework for such a determination. According to the regulation applicable to section 166: "The question whether a debt is a non-

135. *Id.* This, too, seems to be a restrictive reading of *Giblin* since the debt in question in that case arose out of a corporation formed on January 22, 1945, and dissolved in 1950. *Id.* at 692, 694-95. Compare the time period in *Giblin* with the length of operation of the corporation in *Deeley*, which was from 1967 through 1971. *Deeley*, 73 T.C. at 1090.

136. *Deeley*, 73 T.C. at 1094. This number alone would seem to qualify the petitioner as a business promoter. However, the court disregarded these entities since he realized no profit from them. *Id.* Apparently the court feels that only successful entrepreneurs meet the promoter standard.

137. *Id.* The court stated that it would focus on twenty-six of the entities but provided data for twenty-seven.

138. *Id.*

139. What successful business promoter would act otherwise?

business debt is a question of fact in each particular case.”¹⁴⁰ A comparison of the cases discussed previously with those discussed below highlights the uncertainty inherent in the application of the “facts and circumstances” test.

The leading case in the lending area is the Fifth Circuit opinion of *Giblin v. Commissioner*.¹⁴¹ The petitioner was an attorney who from 1926 to 1945 endeavored to leave the legal profession by forming several diverse corporations. The Tax Court sustained the Commissioner’s deficiency determination because the petitioner was not in the business of making loans to corporations.¹⁴² The Fifth Circuit reversed. Citing the *Higgins* “facts and circumstances” test, the court said that normally the Tax Court’s findings on the issue are critical. However, the court said that in this case the Tax Court’s findings were inconclusive because it based its analysis on the fact that the petitioner was not in the business of making loans to corporations.¹⁴³ According to the Fifth Circuit, the Tax Court did not “really come to grips with the issue.”¹⁴⁴ The Fifth Circuit reversed because it felt the petitioner was in the business of promoting, organizing, and investing in corporations.

However, the Tax Court had considered and rejected this claim. According to the Tax Court: “[W]hile the record shows that for some years prior to the taxable year in question the petitioner also promoted, organized, and invested in various corporations and other business enterprises, the evidence does not show he was so engaged in the taxable year.”¹⁴⁵ The Fifth Circuit found this statement to be contrary to fact and decided that the Tax Court *meant to say* that the petitioner was not engaged in the business of making loans during the taxable years.¹⁴⁶ Thus, the Fifth Circuit reversed on a factual basis, leading one to the conclusion that the “facts and circumstances” presented there were different from those found by the Tax Court.

The taxpayer in *Mahoney v. Spencer*¹⁴⁷ created three corporations to carry on a canning operation which he had previously conducted as an individual. The taxpayer leased three canning plants,

140. Treas. Reg. § 1.166-5(b)(2) (1959).

141. 227 F.2d 692 (5th Cir. 1955).

142. *Giblin v. Comm’r*, 13 T.C.M. (CCH) 1009, 1011 (1954).

143. *Giblin*, 227 F.2d at 697.

144. *Id.*

145. *Giblin*, 13 T.C.M. (CCH) at 1011.

146. *Id.*

147. 172 F.2d 638 (9th Cir. 1949).

one to each of the three corporations. He also agreed to provide adequate financing to each corporation when required. In fulfilling this obligation, he guaranteed over three hundred notes for a total of \$700,000. A considerable amount of this credit involved the taxpayer mortgaging his own properties. The taxpayer spent at least a third of his time discharging his financing obligations. The remaining two-thirds of his time was spent in performing corporate functions as president of the three corporations.¹⁴⁸

The district court found that the taxpayer was engaged "in the business of acquiring, owning, expanding, equipping and leasing food processing plants."¹⁴⁹ The Ninth Circuit agreed, noting that his activities were "extensive, varied, continuous and regular."¹⁵⁰

A similar result was reached in the memorandum decision *Yewdall v. Commissioner*.¹⁵¹ The taxpayer in *Yewdall* worked exclusively as a certified public accountant prior to 1945. He continued in this business in later years but only devoted a portion of his time to it. Beginning in 1945, the taxpayer decided to finance, promote, loan money to and borrow money for various corporations, using his established credit.¹⁵² When one of his corporations became insolvent, he deducted the amount of the loan.

The Commissioner, in determining deficiencies for 1946 and 1947, disallowed bad debt deductions totaling approximately \$14,000 and stated that the debts were nonbusiness bad debts. The Tax Court ruled for the taxpayer, stating that he

devoted a substantial part of his time during the taxable years to the affairs of various corporations which he promoted, financed, and helped to operate. He testified that after limiting his activity as an accountant, he decided to finance, promote, loan money to and borrow money for various corporations, using his established credit, and he actually spent a substantial amount of his time borrowing money for, lending money to and working with several corporations in an effort to conduct their affairs successfully. The evidence is not overwhelming in his favor but justifies the conclusion that the debts due from [the insolvent corporation] were business debts rather than non-business debts within the meaning of section 23(k).¹⁵³

148. *Id.*

149. *Mahoney v. Spencer*, 73 F. Supp. 657, 658 (D. Or. 1947).

150. *Mahoney*, 172 F.2d at 640.

151. 13 T.C.M. (CCH) 248 (1954).

152. *Id.*

153. *Id.* at 252. Section 23(k) is now I.R.C. § 166(a) (CCH 1983). Similar results were

The lack of overwhelming evidence indicates the uncertainties in this area. The taxpayer was only involved with five corporations over a four-year period during which time he worked part-time as a certified public accountant. As the court indicated, the facts narrowly led to the conclusion that his activities had risen to the level of a trade or business.

The Tax Court reached a similar result in *Campbell v. Commissioner*.¹⁵⁴ The court allowed the deduction of the petitioners' loans to their corporation as a business bad debt because they were in the business of organizing and operating corporations engaged in the retail coal business. The petitioners had twelve such corporations. Since the loans had a direct connection with their business of operating coal corporations, they were entitled to the deduction as business bad debts.¹⁵⁵

The *Campbell* decision was apparently partially overturned by *Whipple*.¹⁵⁶ The *Whipple* Court said that one who actively engages in serving his own corporation for the purpose of creating future income is not in a trade or business.¹⁵⁷ The Court said: "To the extent that they hold or contain statements to the contrary, we disapprove of such cases as . . . *Campbell*. . . ."¹⁵⁸ Whether the Tax Court's decision in *Campbell* stands for the proposition disapproved in *Whipple* is questionable. The losses incurred in *Campbell* were, according to the Tax Court, "directly a result of . . . the business of organizing and operating corporations."¹⁵⁹

In *Commissioner v. Moffat*,¹⁶⁰ the issue was whether a taxpayer's leasing of coal lands to his corporation constituted a trade or business. The taxpayer was originally engaged in the business of mining his land as a sole proprietor. He later decided to incorporate and eventually ended up subsidizing the corporate debt, deducting those amounts as business bad debts.¹⁶¹ The Tax Court found that Moffat was

very actively and constantly engaged in the business of owning, leasing and seeing to the proper operation of his coal lands. . . .

reached in *Scott v. Comm'r*, 14 T.C.M. (CCH) 1029 (1955).

154. 11 T.C. 510 (1948).

155. *Id.* at 511-12.

156. *Whipple*, 373 U.S. at 203 n.10.

157. *Id.* at 203.

158. *Id.* at 203 n.10.

159. *Campbell*, 11 T.C. at 512.

160. 373 F.2d 844 (3d Cir. 1967).

161. *Id.* at 845.

His guarantee of the Moffat Coal Company borrowing as well as his payment of the indebtedness in 1960 were not only proximately but directly related to that business. . . . The argument that this debt was not a business debt is refuted by the evidence presented.¹⁶²

The Third Circuit affirmed, concluding that the factual determination made by the Tax Court was not clearly erroneous.¹⁶³ The court also agreed with the Tax Court's determination that the loans were directly related to the taxpayer's leasing business, thus entitling him to a business bad debt deduction.¹⁶⁴

V. CONCLUSION

The *Ditunno* opinion noted that other courts have used the "facts and circumstances" test without problems. Judge Tannenwald predicted that havoc would accompany the abandonment of the "holding one's self out" criteria. As is the nature of the "facts and circumstances" test, the determination is certainly subjective and each case is decided on the facts presented. There is unpredictability with such an approach, however, because there are no established fact patterns to which a court can refer. Does one rely on the number of investments made, the value of these investments, the number of closely-held corporations developed, the number which were successful, the amount loaned to the businesses, or other factors? Clearly, the fewer the fixed criteria that are available the more discretion is available to both the taxpayer and the Service.

Perhaps the safest generalization which can be made is that one should not count on being classified as being in the trade or business absent solid factual support. The maxim that deductions are a matter of legislative grace is inherent in the judicial decisions. Courts are more likely to agree with the Service that "trade or business" status is not easily attained.

However, contrary judicial authority is available. The phrase's evolution is now at the stage where one relies on the facts of each individual case to determine trade or business status. The problem is that no one is certain of which facts are sufficient. Facts which are dispositive to some courts are relatively insignificant to others.

162. *Moffat v. Comm'r*, 24 T.C.M. (CCH) 961, 964 (1965).

163. *Moffat*, 373 F.2d at 847.

164. *Id.*

Certainty in the tax law would be better served if more, instead of less, specific criteria were established.

